

Impact Analysis of demonetization in india

Kirandeep Kaur¹
Seema Sharma²
Savita Garg³

Abstract

Prime Minister Narendra Modi came out with his master stroke on corruption, counterfeit currency, terrorism and black money by announcing demonetization and ceasing Rs 500 and Rs. 1000 notes as a part of legal tender in India.

The term demonetization is not new to the Indian economy. The highest denomination note ever printed by the Reserve Bank of India was the Rs 10,000 note in 1938 and again in 1954. But these notes were demonetised in January 1946 and again in January 1978, according to RBI data. Since less than 5 percent of population in India had access to such notes and most banks never had such currency notes, demonetization did not have a big impact on the country. The decision was taken to curb the illegal use of high denomination currency which was used for corrupt deals in the country.

However, with the latest round of demonetization, the common public and bankers are undoubtedly facing hardship since more than 85 percent of currency in circulation has been rendered illegal in one single stroke. Demonetization is surely hampering the current economy and will continue to do so in the near term and will also impact India's growth for the coming two quarters but will have positive long lasting effects. The question that arises is why demonetization was required at this point of time. There are certain pros and cons of demonetization. In present communication, some of the major pros and cons of demonetization are described.

Keywords: Demonetization, pros of Demonetization, Cons of Demonetization

1. GZSCCET, Bathinda,
2. GZSCCET, Bathinda
3. YCOE, Talwandi sabo

On November 8, Indian Prime Minister Narendra Modi took a historic decision by announcing that the high-denomination notes (Rs 500 and Rs 1,000) then in circulation would cease to be legal tender.

With demonetization effort 86% of India's currency was nullified that aimed to wash the stock of 'black market's cash supply' and counterfeit notes out of the economy and convert it into the

licit, banked and taxable, part of the economy. To reduce the impact of sudden commercial collapse, a 50 day period ensued where the population could (ideally) exchange their canceled cash for newly designed 500 and 2,000 rupee notes or deposit them into bank accounts. Irrespective of the widespread anguish and household disturbances, an optimistic sentiment shown in favour of the decision.

Cash is the preferred mode of transaction in India and only less than half the population uses banking system for monetary transactions. An immediate public anger appeared against the mismanaged and unprepared banking system. The banks didn't have enough of the newly designed banknotes (Rs 500 and Rs 2000) to distribute in exchange for the canceled notes. The move has also led to a shortage of lower denomination notes such as Rs 100 and Rs 50 that are still legal tender, as people have taken to conserving whatever cash they have in hand. The demonization initiative has caused a sudden breakdown in India's commerce and the unbanked and informal economy is hard hit. Trade across all aspects of the economy has interrupted, and sectors like agriculture, fishing, and the huge informal market were almost shut down during the initial days of announcement. The informal sector in India employs more than a majority of the workers and most transactions are in cash. Disruption to this system could endanger the employment and livelihood of weaker sections of society. The change disturbed the lives of ordinary people, led to widespread need and major job losses for the poor

The plan was an attempt by the government to wash the stock of counterfeit money out of the economy, which has allegedly been used to fund criminal activities, such as terrorism and drug trafficking. In addition, the scheme aimed to draw a large part of the black economy into the banked and taxable part of the economy (overall tax revenue to GDP is a meagre 11%). The demonetization plan could be beneficial for India in the longer run, as it will lift government revenues due to a broader tax base and less tax evasion. In addition, the operation will foster the use of bank accounts and digital payments, making the Indian economy less cash-dependent and improve efficiency and productivity. But, demonetization is surely hampering the current economy and will continue to do so in the near term and will also impact India's growth for the coming two quarters but will have positive long lasting effects. The question that arises is why demonetization was required at this point of time. There are certain pros and cons of demonetization.

Pros

One of the biggest benefits of this move is that it is going to drastically affect the corrupt practices. People who are holding black money in cash will not be able to exchange much as they would be in a fear of getting penalised and prosecuted by the authorities. Enemies of the country

which are involved in counterfeit currency and terrorism will not be able to continue it further for quite some time at least. The smuggling of arms and dealing with the terrorist will not sustain further as all of the money will be on record now. Secondly, the banking system will improve as it will slowly head towards a cashless society. Cashless society will increase credit access and financial inclusion. The existing white money of people will be known to the government and it will remain with banks so that it can be put on loan, and interest can be generated from it (though interest rates would fall with a corresponding fall in Inflation.

Further Banking System will get a boost, as more than Rs 7-8 lakh crore base money (new legal money) will enter the system. However, it needs to be seen how much money actually remains in the system, once the cash withdrawal limits are eased.

Thirdly, it will reduce the risk and cost of cash handling as soft money is safer than hard money. It will also reduce government liability. Since every note is a liability for the government, the old currency will become worthless for those people, who choose not to disclose their income. Thus, this will extinguish government's liability to that extent. It is expected approximately Rs 5 lakh crore may come to the government in the form of extinguished RBI liability, taxes and penalties. This amount is enough to take care of India's entire fiscal deficit for one year or more.

It will also reduce tax avoidance. Whatever money will be deposited or exchanged, authorities will keep a track of it and they will be extra cautious in this period. Dealing in this period in sectors like jewellery and real estate will be on radar and those entering into Loan transactions may also undergo tax scrutiny. Search and Seizure activities of the IT Department will also rise to curb such malpractices. Limits have already been prescribed for reporting to the IT Department those bank accounts in which excess cash deposits are being made in this 50-day window (Rs 2.5 lakh in case of individuals and Rs 12.5 lakh in case of firms).

Importantly, in the longer run, tax and interest rates on loans are expected to come down as higher income tax collections arising from better compliance would offer scope to reduce rates over the long term. This, in turn, will drive up disposable income. This can give a positive impact on consumption demand in long term.

Cons

The liquidity squeeze caused by demonetization will be negative across sectors with high level of cash transactions. Real estate, jewellery, retailing, restaurants, logistics, consumer durables and luxury brands, cement and some segments in retail/SME lending space will be facing short term

instability. Those companies with high level of debt will face more pressure and can face loan defaults.

Secondly, there will be an added replacement costs of currency. We cannot ignore the increased cost of operating ATMs need to be refilled more often and also it will be a huge burden on banks. Initially, it is very difficult to create a cashless society as more than 50 percent of Indian population is not well versed with card transactions. Also for these initial months, it will be very difficult to make cash transactions of a higher amount. But the government is taking steps to improve liquidity into the system and reduce inconvenience as much as possible.

India is certainly going to experience "Acche Din" in Modi's regime. The decision of this surgical strike on black money was not taken in a day or two. Rome was not built in a day and similarly, this plan is the result of Prime Minister's meticulous planning and never ending fight against corruption. As a result, he has successfully made the right stroke at the right time.

Further, the penal provisions are hefty enough to ensure that corrupt practices will find it hard to take roots again. Despite certain short term troubles, demonetization is certainly going to give a boost to the Indian economy in the long run. As of now, all of us should stand and support this bold move of our Prime Minister and help those needy, around us.

Conclusions

Although the effect of demonetization perhaps did not cause the economic hurricane that some analysts expected, we believe the slight puff of headwind that the economy has faced up till now won't be all of it. Ultimately, the negative effects are dependent on the period of time before liquidity in the economy has returned to pre-demonetization levels. The gap between former and current levels is still substantial and we believe the negative effects on the Indian economy might reveal themselves in upcoming revisions of GDP or when more reliable informal sector data is released next year.

References

https://en.wikipedia.org/wiki/2016_Indian_banknote_demonetization

<http://www.livemint.com>

<https://www.managementstudyguide.com/demonetization-impact-on-indian-economy.htm>

<https://www.quora.com/What-will-be-the-impact-of-demonetization-in-India>

http://www.moneycontrol.com/news/economy/impact-analysisdemonetizationindia_8044821.html

https://www.hdfcbank.com/assets/pdf/Event_Update_Demonetization_and_its_impact.pdf